21 Sep 2018

EM Asset Allocation | Hard-currency debt

Differentiating risks among EM and FM sovereigns

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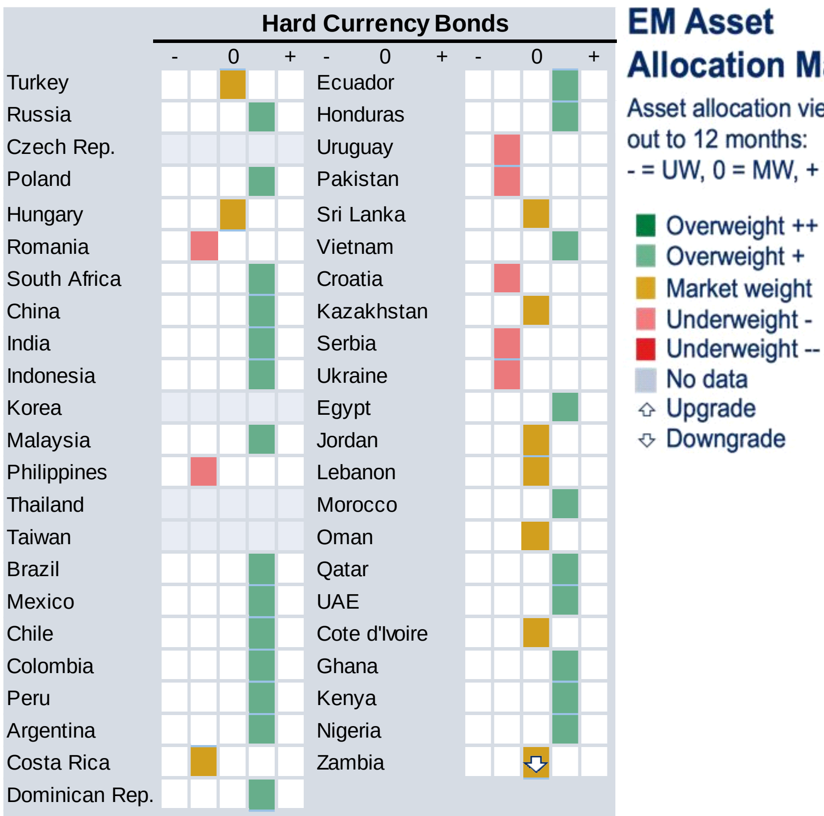
- **We retain an overweight allocation to EM hard-currency sovereign debt. We think the widening of spreads over the summer has left valuations attractive and the asset class will attract EM investors reluctant to bear FX risk. Hence, hard-currency debt is also a safety proposition for us. However, we are still keeping frontier markets at arm's length, amid tighter dollar liquidity and deteriorating risk profiles.**

- At an aggregate level, most hard-currency losses have come because of frontier markets, to which most indices such as EMBI are heavily exposed. Worsening EM growth prospects have also contributed to spread widening. However, concerns over creditworthiness and liquidity seem to be less potent forces, given longer-dated maturities and uneven external financing needs among EMs and FMs.

- We continue to retain the largest overweight in our portfolio on EM hard-currency debt, at the expense an underweight position on frontiers. Our highest-conviction calls are still in Latin America, where the widening of spreads induced by political uncertainty have created the largest misalignments relative to fundamentals. Elsewhere, we downgrade Zambian bonds given the higher probability we now attach to debt distress.



EM Asset Allocation Matrix

Asset allocation views out to 12 months:
- = UW, 0 = MW, + = OW

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Differentiating risks among EM and FM sovereigns

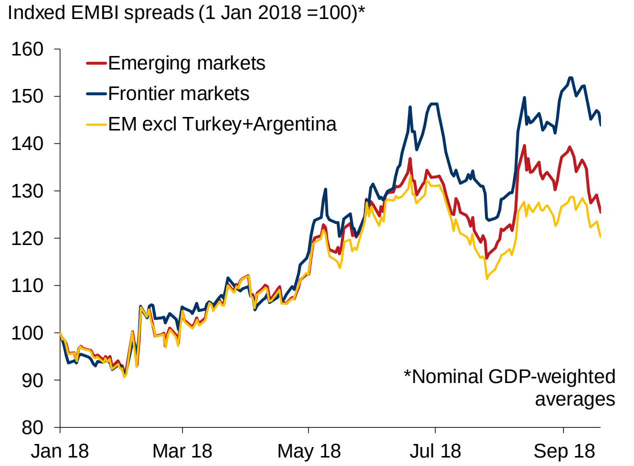
FM and EM credit paths remain divergent

September has brought a welcome respite for hard-currency sovereign debt, with spreads retracing some of the sharp widening at the end of summer. That said, we continue to observe a marked divergence in the paths of spreads for mainstream emerging and frontier markets, with the latter (blue line in **Chart 1**) continuing their divergence from the former (red line) since late June. This is a theme we alluded to last month, when we noted that tighter dollar liquidity amid concerns over a build-up of FX debt has left frontier markets looking riskier and more vulnerable, justifying our underweight stance ("Cheap valuations can absorb liquidity shocks" 23 Aug). Notably, while the crises in Turkey and Argentina caused spreads for both EM and FM to spike, the overall GDP-weighted average has seen much more modest moves (yellow line) and has retraced almost all losses since early August.

Deteriorating frontier market fundamentals have been a key driver of sovereign-credit underperformance, given the heavy concentration of frontiers in EMBI. The performance EM hard-currency bonds relative to US HY has fallen dramatically since April, coinciding with the surge in the dollar. However, that is probably not the whole story. As **Chart 2** shows, this underperformance has tracked closely the trajectory of the relative performance of frontier equities to global equities, suggesting that deteriorating FM growth fundamentals have been an important driver of widening FM spreads too. While concerns about liquidity and positioning are valid, we think FM weakness has soured the overall picture. Hence, we think, much greater differentiation is warranted.

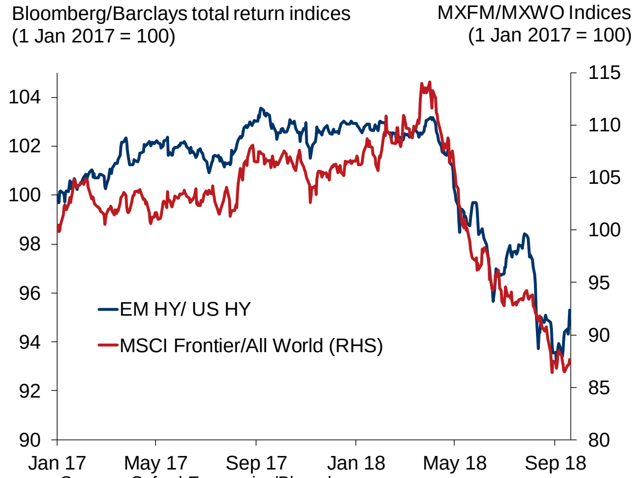
The overarching backdrop for hard-currency assets continues to be one of softening EM growth. We explored this theme in the Local Rates & FX section, noting that poor EM growth has been a central reason for the underperformance of EM local rates too. A repricing of growth prospects is keeping pressure on hard-currency debt, though we are overweight because it helps us minimise FX exposure. As **Chart 3** shows, the widening of spreads since the beginning of the year can be clearly traced to faltering EM growth expectations, proxied here by the cheapening of equity valuations from rather expensive levels. In this context, the extent to which China is able to ramp up its stimulus measures to minimise the repercussions of trade tensions with the US will be an important determinant of whether EM hard-currency assets find a more solid footing ("China easing holds key to EM recovery" 11 Sep).

Chart 1: Credit spreads widened again in August, but driven mostly by frontier markets



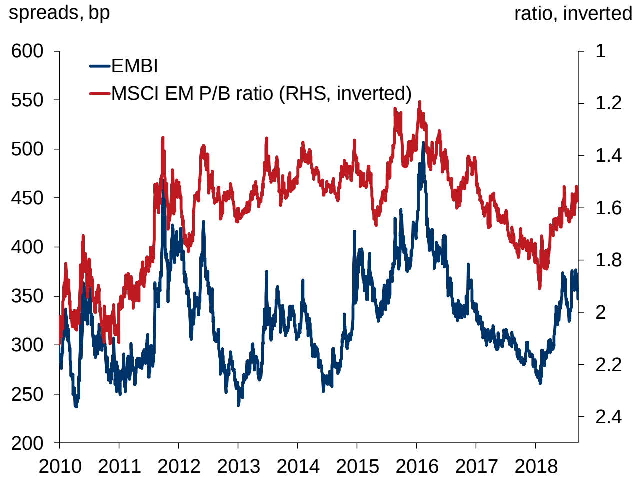
Source : Oxford Economics/Haver Analytics

Chart 2: EMBI spread widening more to do with deteriorating FM fundamentals than liquidity



Source : Oxford Economics/Bloomberg

Chart 3: Slowdown in EM growth relative to DM also keeping sovereign debt under presssure



Source : Oxford Economics/Bloomberg

Differentiating risks among EM and FM sovereigns

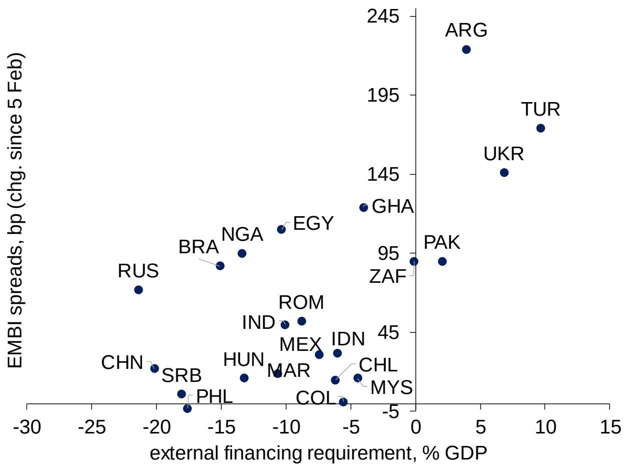
Migitating factors against liquidity shocks

Tighter dollar liquidity has been a core driver of spread widening, albeit its impact has been uneven across countries. EMs and FMs with large FX mismatches and/or excessive reliance on FX funding have suffered the most from the dollar-liquidity tightening, judging by the widening of spreads since their lows in early February – countries with most spread-widening are also those with the highest external financing requirements (**Chart 4**). The hardest-hit have been those in or close to having IMF programmes, such as Argentina, Pakistan, Ukraine, Ghana, and Egypt, but spreads have also widened to reflect political and idiosyncratic developments in Brazil, Russia, and Turkey.

A narrow focus on liquidity shortages probably misses the point, however. There are mitigating factors at play. First, as we've noted before, currency mismatches among EM are fewer, given the increased issuance of debt in local currencies and at longer tenors ("The dollar liquidity threat to EM" 30 Aug). And, perhaps more importantly in an environment of rising global rates, the fact that EMs rely less on variable rates than their DM counterparts (**Chart 5**) suggests the impact of higher borrowing costs may be felt with a delay. The majority of debt issued by banks and corporates has been issued at fixed rates. There are notable exceptions, such as in Egypt and South Africa, where banking sectors are exposed to variable-rate debt, and in Thailand, where the exposure is on the corporate side.

Interestingly, corporate spreads appear to be less under pressure than sovereign spreads, suggesting that concerns over creditworthiness may not necessarily be the most important driver of spread-widening. Since the EM sell-off following Trump's election, EM corporate bonds have offered lower yields than sovereign dollar bonds. **Chart 6** shows that hasn't always been the case. In fact, with the exception of a few countries, EM corporate bonds have typically yielded more than sovereigns, especially during the pre-taper tantrum years, which is intuitive since corporates are typically benchmarked to the sovereign and normally have a positive risk premium. What is interesting about the chart is that, in contrast to typical EM risk-off episodes, yields on EM corporate debt have not widened relative to those on sovereign debt. This can reflect several possibilities (1) perhaps investors see some EM corporate sectors as having better governance than sovereigns, (2) EM corporates have fewer FX liability mismatches, (3) EM corporate debt is infrequently marked to market. We shall address this issue in future research.

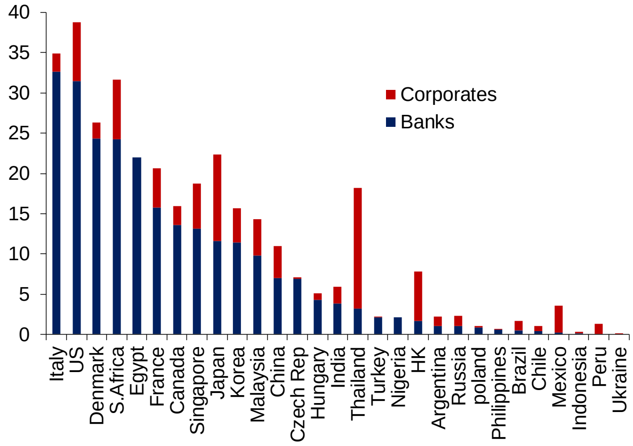
Chart 4: Wider spreads have been concenrated in countries with higher financing needs



Source : Oxford Economics/Haver Analytics

Chart 5: Higher reliance on fixed rates to help insulate EM credit against liquidity shocks

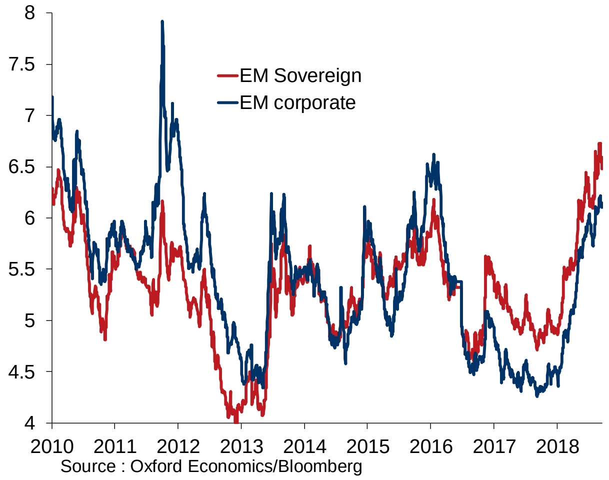
% of outstanding int'l bonds relying on variable rates



Source : Oxford Economics/Haver Analytics/BIS

Chart 6: Corporate spreads haven't widened as much as sovereign – are credit fears overdone?

%, Bloomberg/Barclays hard-currency debt yields



Source : Oxford Economics/Bloomberg

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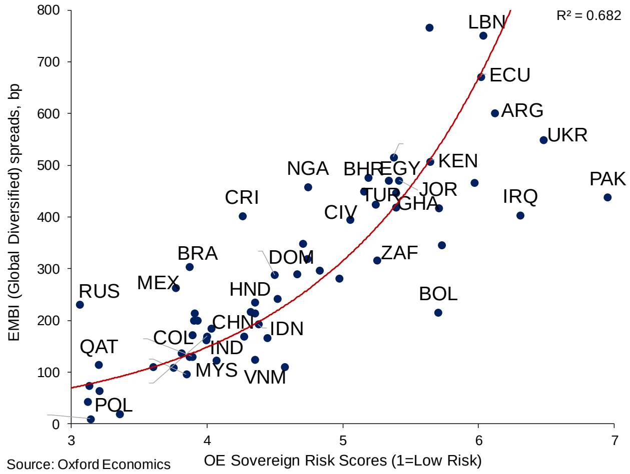
Still overweight on EM sovereigns, but not FM

The largest overweight in our EM model portfolio is on hard-currency debt, where we think the widening of spreads has left select sovereigns looking valuable. **Chart 7** shows the extent to which sovereign spreads, especially in mainstream EMs, have widened relative to what would be suggested by our Sovereign Risk Indicator, which aggregates macro fundamentals and vulnerabilities. Some of our most high-conviction calls are in Latin America, where we think the widening of spreads has been mostly due to political considerations (whether election uncertainty in Brazil, or NAFTA in Mexico), leaving sovereign credit looking overpriced relative to fundamentals. Russia follows the same script. We are closely monitoring South Africa, where our model suggests that dollar bond spreads could still rise further, while Turkish credit is on our watch list for an upgrade given latest policy announcements, while still in early stages, to deal with the corporate debt problem.

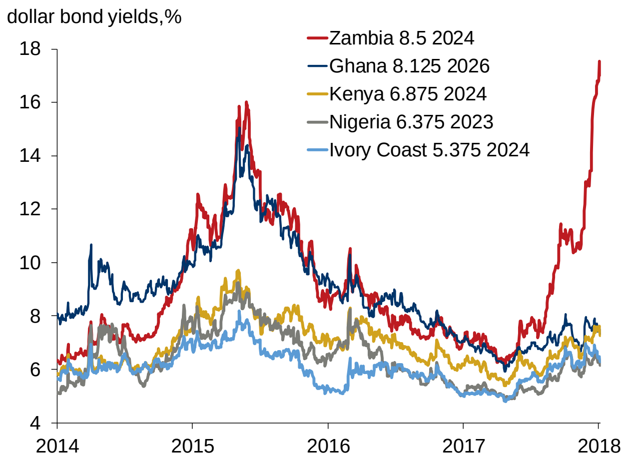
Our confidence in our call on Zambian dollar bonds has deteriorated rapidly, and we now downgrade our exposure to neutral. Zambia has had a roller coaster of a summer, with successive credit rating downgrades on the back of a widening fiscal deficit and an unabated pace of debt accumulation. Meanwhile, talks with the IMF on a potential bailout package remain stalemated, and we do not expect a successful conclusion of a deal this year. Large downside risks loom: an inadequate front-loaded fiscal response along with weakening reserve buffers will necessitate further contraction of external debt in the absence of a bailout package. External debt liabilities account for the largest share of public sector debt, and exchange rate depreciation is contributing to external and fiscal fragility. And, in the context of a narrow export base, weak external buffers and copper dependence, we now attached a higher probability of debt distress, and expect further upward revisions to the public debt burden. In that light, the spike in Zambian bond yields relative to peers doesn't look excessive (**Chart 8**).

Chart 7: Mainstream EMs looking more valuable relative to underlying macro fundamentals



Source: Oxford Economics

Chart 8: Spike in Zambian eurobond yields pricing in higher probability of debt distress



Source : Oxford Economics/Bloomberg

Differentiating risks among EM and FM sovereigns

Hard currency fixed income dashboard

19 September 2018

	EMBI Spreads (bps)	Change compared to		Current account balance (% GDP)		Government balance (% GDP)		External debt (% GDP)	
	Current	Last month	Last year	2017	z-score	2017	z-score	2017	z-score
Emerging and frontier markets									
Turkey	478	-99	203	-5.5	-0.2	-1.6	0.3	59	2.7
Russia	240	4	66	2.3	-0.9	-1.3	-0.1	37	0.9
Czech Rep	-	-	-	1.1	1.2	-0.1	1.0	89	2.3
Poland	53	-17	4	0.2	1.3	-1.6	-1.5	73	0.9
Hungary	112	-17	22	3.2	0.6	-1.9	1.0	94	-1.4
Romania	177	-2	58	-3.4	0.2	-2.8	0.4	50	-0.9
South Africa	332	26	78	-2.5	0.9	-3.4	0.2	45	1.1
China	187	1	36	1.3	-0.8	-3.6	-1.5	14	0.9
India	167	14	48	-1.6	0.6	-4.1	0.7	19	-0.4
Indonesia	204	10	33	-1.7	-0.3	-2.6	-1.0	34	1.1
Korea	-	-	-	5.1	0.3	1.4	0.7	28	-1.3
Philippines	137	1	2	-0.7	-1.6	-2.2	-0.2	26	-0.9
Malaysia	106	-4	16	2.9	-0.9	-3.0	1.1	69	1.0
Thailand	-	-	-	11.2	1.5	-2.9	-0.8	31	0.1
Taiwan	-	-	-	14.4	1.4	-0.1	1.1	33	1.1
Brazil	326	32	76	-0.5	1.8	-7.8	-1.0	16	0.6
Mexico	270	-14	32	-1.7	-0.2	-1.0	1.3	40	1.6
Chile	134	-7	9	-1.5	0.1	-2.7	-0.8	62	1.2
Colombia	177	-11	-7	-3.3	0.2	-3.2	-0.6	41	1.6
Peru	141	-12	2	-1.3	1.0	-3.2	-1.6	36	1.7
Argentina	695	1	311	-4.9	-1.8	-5.8	-1.2	34	0.2
Costa Rica	410	27	53	-2.9	0.8	-6.2	-1.0	47	1.5
Ecuador	707	4	80	-0.3	-0.1	-4.5	-0.5	31	1.3
Honduras	256	-16	-10	-1.7	1.3	-2.7	1.0	38	1.2
Uruguay	172	-7	7	1.6	1.8	-3.0	-1.1	65	0.2
Pakistan	469	-12	131	-5.2	-0.8	-5.8	0.3	27	-0.6
Sri Lanka	431	51	154	-2.6	0.4	-5.5	0.8	56	1.0
Vietnam	136	-19	-18	2.8	0.5	-3.5	-0.2	42	0.9
Croatia	105	-24	-20	3.7	1.0	-0.2	1.6	92	-0.5
Kazakhstan	210	-14	-7	-3.4	-0.8	-2.8	-0.9	103	1.1
Serbia	119	-16	-4	-5.6	0.5	0.8	1.7	76	-0.1
Ukraine	549	-23	97	-1.9	0.6	-2.4	0.8	110	0.7
Egypt	480	-14	71	-4.1	-0.8	-10.7	-0.4	36	2.8
Jordan	427	-8	71	-8.1	0.5	-2.6	1.2	73	1.2
Lebanon	790	121	344	-17.8	0.4	-7.3	0.7	64	-0.4
Morocco	171	-21	15	-3.5	0.9	-3.6	0.2	48	1.6
Oman	-	-	-	-12.7	-1.2	-13.5	-1.0	64	2.6
Qatar	-	-	-	3.8	-1.1	-5.8	-1.4	60	0.6
UAE	-	-	-	6.9	-0.4	-0.2	0.5	84	1.9
Cote d'Ivoire	436	-31	69	-1.6	-0.8	-4.3	-1.4	32	-0.8
Ghana	494	-36	29	-4.2	2.0	-5.9	0.9	48	1.0
Kenya	540	45	134	-6.7	0.2	-9.0	-1.6	33	1.8
Nigeria	487	-22	92	2.8	-0.1	-5.8	-1.1	11	2.6
Zambia	1272	318	755	-2.9	-0.8	-7.3	-1.1	41	1.3